IN THE

Supreme Court of the United States

OCTOBER TERM—1947.

No. 384.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

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This is a proceeding to review a judgment of the Circuit Court of Appeals for the Fifth Circuit which reversed a decision of The Tax Court of the United States. The Tax Court had found that there was a deficiency in the federal excess profits tax of respondent for the year 1943. The amount of the deficiency in controversy is $1,708.53 (R. 30).

Opinions Below.

The opinion of the Tax Court (R. 30) is reported in 7 T. C. 669. The majority (R. 51) and dissenting (R. 54) opinions in the Circuit Court of Appeals are reported in 162 F. (2d) 866.

Jurisdiction.

The jurisdiction of this Court is invoked under §240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Whether, under §115(l) of the Internal Revenue Code, the respondent's profits from installment sales are includible in full in its earnings and profits as of the beginning of subsequent years for the purpose of computing its invested capital credit for such years under the excess profits tax.

Statutes and Regulations Involved.

The statutes and regulations involved are set out in the Appendix, *infra*, pp. 49-59.

Statement of Case.

(a) How the question arises.

The respondent taxpayer, a corporation, sold parcels of real estate in 1937, 1938 and 1941, gave deeds therefor to the purchasers and received in payment cash and promissory notes executed by the purchasers, payable to the order of the taxpayer, and secured in each case by vendor's lien and mortgage lien against the land (R. 31). The taxpayer keeps its books and files its income and excess profits tax returns on the calendar year and accrual basis (R. 31). The taxpayer, being on the accrual basis of accounting, carried on its books as receivables the installment obligations received from such sales (R. 31). The gain from such sales was reported for income tax and excess profits tax purposes

under the installment provisions contained in §44(b)* (R. 31).

The taxpayer computed its excess profits tax by use of the credit for invested capital as authorized by §§710 and 712 (R. 17, 22-23). The credit, which is against excess profits net income, was, in the case of the taxpayer, 8% of its invested capital (§714) (R. 17). The definition of invested capital involves the determination of the corporation's "equity invested capital" which is defined as including "the accumulated earnings and profits as of the beginning of such taxable year" (§718(a)(4)).

The taxpayer computed its excess profits credit for 1943, and its unused excess profits credit carry-overs from 1941 and 1942, by including in its accumulated earnings and profits at the beginning of such years the full amount of its profits on installment sales made in previous years (R. 33-34). The Tax Court held that the taxpayer's earnings and profits did not include the portion of such profits allocable to installments which had not been collected. The Tax Court rested its decision upon its prior decision in *Kimbrell's Home Furnishings, Inc.*, 7 T. C. 339 (1946), afterwards reversed by the Fourth Circuit Court of Appeals (159 F. (2d) 608 (1947)).

The court below reversed the decision of the Tax Court. In so doing the court below followed its prior decision in *Comm'r* v. *Shenandoah Co.*, 138 F. (2d) 792 (1943), holding that uncollected profits from installment sales were includible in earnings and profits for the purpose of determining whether a distribution to stockholders was a dividend. The Commissioner agrees that, although a different tax is involved, the ultimate question here is precisely the same as the question presented in the *Shenan-*

* Unless otherwise indicated all section references are to the Internal Revenue Code.

doah case and is governed by the same statute there involved, *viz.*, §115(l) (petitioner's brief, p. 13).

Section 115(l), which is conceded to be controlling here, was not discussed or even referred to by the Tax Court either in its decision in the present case or in its prior decision in the *Kimbrell* case, which it followed here.

(b) The issues.

If the taxpayer had not elected to report the gains from such sales on the installment basis, the full amount of such gains would have been taxable in the years the sales were made (Reg. 111, §§29.44-3, 29.44-4) and, as the court below pointed out (R. 53), the Commissioner would then concede that the profits from such sales were fully includible in the taxpayer's earnings and profits at the dates involved even though a part of such gains remained to be collected. There is, therefore, no objection to the includibility of such profits on the ground that they had not been collected, *i.e.*, that they were represented by installment obligations payable in the future.

The sole ground of objection by the Commissioner to the includibility of the uncollected profits in respondent's earnings and profits as of the beginning of the taxable years involved is that the respondent, having availed itself of the privilege of reporting such profits on the installment basis, had not previously paid an income tax thereon.

The taxpayer's position is that the case is controlled by §115(l), enacted by §501 of the Second Revenue Act of 1940. Section 115(l) defines the effect on earnings and profits of gain or loss from the sale or other disposition of property. The section is controlling in the determination of the invested capital credit under the excess profits tax as well as in the determination of whether a distribution is a dividend.

Under the terms of that section the full amount of the taxpayer's gains from its installment sales was required to be included in the earnings and profits of the taxpayer because such gains were (i) realized upon the sale and (ii) were "recognized in computing net income under the law applicable to the year" of sale. No other requirements are contained in §115(l) for inclusion of gain in earnings and profits. Specifically, there is no requirement in §115(l) that gain (or loss) must be included in (or deducted from) taxable income before it "shall increase or decrease the earnings and profits."

In the court below, and again in the petition for certiorari, the Commissioner's principal contention was that the portion of the taxpayer's profits from its installment sales which had not been included in taxable income was not recognized within the meaning of §115(l). His brief below argued (p. 48): "* * * recognition of gain from the sale or other disposition of property for tax purposes involves its inclusion in gross income under the method of returning income used by a taxpayer." His petition for certiorari asserted (p. 10) that "the gain on an installment sale is 'recognized' under Sections 111 and 112 to the extent that it is subjected to tax in a given year under Section 44." This contention, which was based upon the false premise that "recognition" and "taxation" are synonymous, is given little weight in the Commissioner's brief here.

Instead, the Commissioner's principal reliance (Point A of petitioner's brief) is on an amendment made to the Treasury Regulations on July 8, 1941 by T. D. 5059 (1941-2 C. B. 125) which provides that a corporation computing income on the installment basis shall, with respect to its installment transactions, compute earnings and profits on such basis, *i.e.*, that only the portion of installment

gains which has been returned for taxation is includible in earnings and profits (Reg. 111, §29.115-3). The taxpayer's answer to this regulation is that it provides a requirement for inclusion in earnings and profits which is contrary to the unambiguous provisions of §115(l) and also to the regulations which the Treasury had promulgated thereunder on December 19, 1940 by T. D. 5024 (1940-2 C. B. 110), now contained in Reg. 111, §29.115-12.

The Commissioner endeavors (Point B (5) of petitioner's brief) to reconcile the 1941 amendment to the Regulations with the provisions of §115(l) on the theory that the amendment deals with the time when gain or loss enters into the computation of earnings and profits, which subject, he implies, is not dealt with in §115(l). The taxpayer's answer to this contention is that §115(l) *does* determine the time when gain or loss "shall increase or decrease" earnings and profits. Earnings and profits can only be determined as of a given date, and §115(l) governs the determination of earnings and profits on such date, whatever it may be. Therefore if, as of the date earnings and profits are to be determined, gain or loss meets the tests of realization and recognition specified in §115(l), such gain or loss must enter the computation of earnings and profits at that date.

Summary of Argument.

Section 115(l) provides that the gain realized from the sale of property (determined on the bases specified in that section) shall increase earnings and profits to, but not beyond, the extent to which such a gain was recognized in computing net income under the law applicable to the year of sale. On the dates in question, the taxpayer's gains from its installment sales made in prior years satisfied the

tests of realization and recognition contained in §115(l) because such gains had been realized in full in the year of sale and recognized in full under the law of the year of sale. Such gains were, therefore, required to be included in the taxpayer's earnings and profits at the dates in question.*

The taxpayer's gains from its installment sales were realized in full at the time of sale because the taxpayer then received the full amount of the selling price in money or money's worth. The secured obligations of the purchasers which the taxpayer received were worth their face value. The taxpayer's gains from its installment sales were no less realized because the taxpayer elected to report such gains for taxation under §44. Realization of gain is not postponed by the fact that the taxpayer is not required to pay an immediate tax thereon. Section 44 acknowledges this because it in terms refers to "the gross profit realized" from a sale and thereby presupposes the determination of realization under other provisions of the statute. The gain realized from an installment sale is therefore to be determined under §111. If the obligations received are worth face, the full amount of the gain is realized upon the sale. Only where the value of the money and obligations received is less than the selling price does any gain remain to be realized subsequent to the sale. The relevant authorities uniformly support the taxpayer's position.

The taxpayer's profits from its installment sales were recognized in full under the law of the year of sale. Section

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* Since §115(l) governs the determination of earnings and profits not only for the purpose of computing the invested capital credit of a corporation, but also for the purpose of determining whether distributions by a corporation are dividends to its stockholders, the position taken by the Commissioner here, if well founded, would mean that a corporation with available funds could, prior to collecting installment obligations held by it, distribute the uncollected portion of its installment gains to its stockholders free of dividend tax.

111(c) provides that "for the purposes of this chapter" the recognition of gain shall be determined under the provisions of §112. Section 112(a) provides that upon a sale the entire amount of the gain, determined under §111, shall be recognized, with exceptions not material here. The statutory phrase used in §115(l), "recognized in computing net income under the law applicable to the year in which such sale or disposition was made", means gain or loss of the kind recognized under §112 of the Code, or corresponding provisions of prior Revenue Acts, applicable to the year of sale.

The phrase in question does not mean that gain must be included in taxable income before it can be deemed recognized within the meaning of §115(l). On the contrary, §115(l) was designed to provide for the inclusion in earnings and profits of gain or loss that had not entered into the determination of taxable income. This is illustrated by the provisions of the section for inclusion in total earnings and profits of increase in value accrued before March 1, 1913 (which is not subject to tax) when the property is subsequently sold. This illustration and other examples of items which affect earnings and profits in a manner different from that in which they affect taxable income, are contained in the Regulations promulgated under §115(l). (Reg. 111, §29.115-12.) These Regulations and the legislative history of §115(l) (including the amendment of the section by the Revenue Act of 1942, regarding wash sales) fully support the taxpayer's construction of §115(l) as referring to gains recognized under §112 rather than to gains included in taxable income.

To construe the phrase "recognized in computing net income" as meaning included in or deducted from taxable income, would deprive the statute of sensible meaning. The statute would then be made to read: "included in or

deducted from taxable income under the law applicable to the year *in which such sale or disposition was made.*" Such a reading of the statute would exclude from earnings and profits gain or loss included in or deducted from taxable income in a year subsequent to the year of sale. This would follow from the fact that inclusion in taxable income under the law of a year *subsequent to the year of sale* would not meet the statutory test. In the case of installment sales, this would mean that no gains reported for taxation in years subsequent to the year of sale could ever enter the corporation's earnings and profits. They could, therefore, be distributed to the corporation's stockholders free of dividend tax.

Petitioner's brief in substance concedes that the phrase "recognized in computing net income" cannot be construed as meaning included in or deducted from taxable income. It states (p. 27) that the phrase in question "merely fixes the law in effect during the year of sale as being controlling". If this is the sole effect of the phrase, it cannot require that gain be included in taxable income before it is includible in earnings and profits.

Since at the dates in question the taxpayer's gains from its installment sales satisfied the tests of realization and recognition, which are the only tests specified in §115(l), it is immaterial that they did not satisfy a third test imposed by the amendment to the Regulations upon which the Commissioner relies (T. D. 5059, now reflected in Reg. 111, §29.115-3). Such amendment, made subsequently to the promulgation of the Regulations under §115(l), provides that earnings and profits shall be determined in accordance with the method of accounting employed in computing net income, and specifies that a taxpayer who reports income on the installment basis shall, with respect to installment sales, compute its earnings and profits on that basis. The

taxpayer submits that this change in the Regulations is, as to installment sales, squarely in conflict with the provisions of §115(l) and therefore invalid. Excess profits tax cases arising under the Revenue Act of 1918, and decided prior to the enactment of §115(l), cannot justify the addition of such provision to the Regulation after the enactment of §115(l).

The amendment to the Regulation cannot be justified on the theory that it deals merely with the time when gain or loss is included in earnings and profits. The question of the time of inclusion is governed by §115(l), which was intended to settle that question. Neither can the change in the Regulation be justified on the authority of *Comm'r* v. *Wheeler*, 324 U. S. 542 (1945), where the Court pointed out in the course of its opinion that " 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either." The *Wheeler* case did not hold, as the petitioner's brief asserts (p. 21), that the time of inclusion in earnings and profits is to be correlated with the time when gain is subjected to tax. The case held that the includibility of gains from sales in earnings and profits is to be determined under the recognition provisions of §112. Section 115(l) is to the same effect.

The court below properly held, on the authority of its prior decision in *Comm'r* v. *Shenandoah Co.*, 138 F. (2d) 792 (1943), that the taxpayer's gains from its installment sales were includible in full in its earnings and profits for the purpose of determining its invested capital credit.

ARGUMENT.

I.

Under §115(l) the taxpayer's earnings and profits at the dates in question are required to include the full amount of taxpayer's profits from its installment sales made prior thereto because such profits were realized in the year of sale and were recognized under the law of that year.

A. Section 115(l) is controlling.

The parties are agreed that §115(l) (Appendix, *infra*, p. 53) is controlling on the question presented, *viz.*, the determination of respondent's earnings and profits for the purpose of its invested capital credit under the Excess Profits Tax Act of 1940, enacted by §201 of the Second Revenue Act of 1940. The Excess Profits Tax Act of 1940, which is contained in Subchapter E of Chapter 2 of the Internal Revenue Code (§710, *et seq.*), does not define the term "accumulated earnings and profits." (See Reg. 112, §35.718-2, Appendix, *infra*, p. 59). Such Act provides, however, that "the terms used in this subchapter shall have the same meaning as when used in Chapter 1" (§728).

The Second Revenue Act of 1940, in §501 thereof, also amended Chapter 1 of the Code by adding subsection (l) to §115. Section 115(l), among other things, defines the effect on earnings and profits of gain or loss from the sale or other disposition of property by a corporation. The purpose of §115(l) was stated by the Committee on Ways and Means in H. R. Rep. No. 2894, 76th Cong., 3rd Sess. (1940-2 C. B. 496, 526) as follows (p. 41):

> "The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends *but also in determining equity invested capital for excess-profits-tax purposes.*" (Italics added.)

As the Commissioner's petition for certiorari states (p. 11), "any residual doubts as to the applicability of Section 115(l) * * * would be resolved by the legislative history of the statute * * *."

B. The effect of §115(l).

Section 115(l) provides in part as follows:

> "(l) Effect on earnings and profits of gain or loss and of receipt of tax-free distributions.—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—
>
> (1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but
>
> (2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.
>
> Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to

which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made."*

The meaning of these provisions must be determined in the light of the provisions of §§111, 112 and 113. Those sections, like §115(l), are found in Supplement B (of Chapter 1 of the Code) entitled: "Computation of Net Income" (Appendix, *infra,* pp. 52-53). Section 111 provides, in subsection (a) thereof, that the amount of gain or loss from the sale or other disposition of property shall be determined by subtracting the taxpayer's basis for the property from "the amount realized" from the sale thereof. Section 111(b) defines "the amount realized" from a sale as "the sum of any money received plus the fair market value of the property (other than money) received." Section 111(c) provides:

> "(c) Recognition of Gain or Loss.—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized *for the purposes of this chapter,* shall be determined under the provisions of section 112." (Italics added.)

Section 112, entitled "Recognition of Gain or Loss", provides:

> "(a) General Rule.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section."

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* Paragraph (1) of §115(l) specifies the basis to be used in "the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital" (Reg. 111, §29.115-12). Paragraph (2) of §115(l) specifies the basis to be used in "the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions" (*ibid.*).

No exception thereinafter contained in §112 is applicable to installment sales of property.*

Section 113 contains the provisions for determining the taxpayer's basis for the property sold which, under §111, is to be subtracted from the amount realized in determining the amount of gain or loss from the sale.

The effect of §115(l) is, therefore, to provide that, for the purpose of determining the earnings and profits of a corporation,

> (i) The gain or loss realized upon a sale or other disposition of property shall be determined in accordance with §111 except as the provisions of §113 regarding the basis to be used in determining the amount of the taxpayer's gain or loss are modified by the provisions of paragraph 1 or 2 of §115(l), and
>
> (ii) The amount of the gain or loss so determined shall increase or decrease earnings and profits "to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made," *i.e.*, the extent to which such a gain or loss was recognized under §112 of the Internal Revenue Code or corresponding provisions of the prior Revenue Acts applicable to the year of sale.

* Section 112(j) refers to the provisions of subsection (d) of §44 requiring non-recognition of gain or loss in the case of the distribution of installment *obligations* in the course of a corporate liquidation which, under the provisions of §112(b)(6), does not result in the recognition of gain or loss with respect to the receipt of such obligations. There is no similar reference in §112 either to the provisions of subsections (a) and (b) of §44 or to installment *sales* of property as such.

The taxpayer's position is that the gain from its installment sales was realized in full in the year of sale for the reasons stated in Point IC below, and was recognized in full under the law of the year of sale for the reasons stated in Point ID below, and that therefore the full amount of such gain is required to be included in the computation of the taxpayer's earnings and profits in years subsequent to the year of sale.

C. The taxpayer's profits on its installment sales were realized in full, in money or money's worth, in the year of sale.

1. Under the provisions of §111 the taxpayer realized gains from its installment sales to the extent that the money and value of the obligations received exceeded the taxpayer's basis for the property sold.

As stated above, §111(b) defines "the amount realized" from the sale of property as "the sum of any money received plus the fair market value of the property (other than money) received." Section 111(a) defines the gain from the sale as "the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain". In the present case the amount of the gain so determined is the same as the amount of gain computed under §115(l). The reason is that the adjusted basis provided in §113(b) for determining gain for the purpose of inclusion in gross income is, in the present circumstances, the basis prescribed by §115(l) for use in computing the amount of gain realized for the purpose of determining earnings and profits.

The matter of valuation of obligations received on a sale is dealt with in the Regulations. They provide (Reg. 111, §29.111-1):

"The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property which is received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value."

The Regulations further provide (Reg. 111, §29.44-4):

"* * * the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

* * * * * *

"If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. * * * Only in rare and extraordinary cases does property have no fair market value."

The obligations received by the taxpayer consisted of promissory notes payable to the taxpayer's order and were secured by the land sold (R. 31). The obligations received were taken on the taxpayer's books at face value (R. 31) and the Commissioner has made no determination that the obligations were worth less than that amount. Such obligations must therefore be deemed to have had a value equal to their face.[6]

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[6] *Pinellas Ice & Cold Storage Co.* v. *Comm'r,* 287 U. S. 462 (1933); *Rusk* v. *Comm'r,* 53 F. (2d) 428 (C. C. A. 7th 1931); *Peyton Du-Pont Securities Co.* v. *Comm'r,* 66 F. (2d) 718 (C. C. A. 2d 1933); *Wolfson* v. *Reinecke,* 72 F. (2d) 59 (C. C. A. 7th 1934); *Moran* v. *United States,* 85 Ct. Cls. 492, 19 F. Supp. 557 (1937), *cert. denied,* 303 U. S. 643 (1938); *W. B. Packman,* 2 B. T. A. 508 (1925); *H. J. Kelly,* 3 B. T. A. 257 (1925); *J. S. Cullinan,* 5 B. T. A. 996 (1927).

As the Regulations under §111 provide (Reg. 111, §29.111-1):

> "The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain."

Therefore, to the extent that the sum of the money and face value of the obligations received by the taxpayer exceeded its basis for the property sold, the taxpayer had a realized gain.

2. The taxpayer's gains were no less "realized" because the taxpayer elected to report such gains for taxation under §44.

The brief for the Commissioner contends (p. 8) that "under Section 44 * * * gains are realized and recognized when installment payments are actually received in cash".* This contention appears to be grounded on the proposition that the provisions of §§41 to 44, inclusive, relating to the time when items of gross income and deductions are reported for the purposes of taxation, may somehow operate to postpone realization and recognition. (The question of the effect of §44 on recognition is discussed in Points ID and IIA below.) With respect to realization, the contention is unsound for the following reasons:

First, it disregards the provisions of §111 which make it plain that realization is a factual matter which is determined by the *receipt* of money or property. Section 111 defines "the amount realized from the sale" in terms of the money and property "received". This Court has recently had occasion to construe §111 in determining the amount realized upon the sale of mortgaged property.

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* Although the Commissioner's assignment of errors in the petition for certiorari raises an issue as to whether the profits from installment sales were "recognized" in full (p. 6), he made no claim that the court below committed error in holding that the full amount of such profits was "realized" in the year of sale.

Crane v. *Comm'r,* 331 U. S. 1 (1947). The Court held that the amount of a mortgage on the property sold was to be included in the amount realized by the seller, although the seller was not liable on the mortgage. *A fortiori,* the actual receipt of installment obligations upon a sale comes within the definition of realization where such obligations have value.

Where the value of the money and obligations received is equal to selling price, the gain is realized in full at the time of sale. Only where the value of the money and obligations received is less than selling price does any gain remain to be realized at a subsequent date. (Reg. 111, §§29.44-4 and 29.111-1.)

Secondly, §§41 to 44, inclusive, having to do with the time that gains and deductions are to be reported for the purposes of taxation, do not purport to affect the question of the time of realization determined under §111. Section 42, which deals with items of gross income generally,* provides:

> "(a) General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period."

Section 41 provides that in computing net income, the method of accounting regularly employed in keeping the taxpayer's books shall be used unless such method does not clearly reflect income.**

* The gain from a sale, as determined under §111, constitutes an item of gross income. §§22(a) and 22(f); *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179 (1918).

** The Regulations under §41 provide (Reg. 111, §29.41-2):

> "Section 44 contains special provisions for *reporting the profit derived* from the sale of property on the installment plan." (Italics added.)

Presumably in reliance on provisions like those of §42, the Commissioner promulgated regulations in 1918 and 1919 providing for the use of an installment method in reporting gain. These regulations are referred to at page 22 of the petitioner's brief, where it is pointed out that after the Board of Tax Appeals had held the regulations invalid in a series of cases decided in 1925, Congress in §212(d) of the Revenue Act of 1926 enacted the installment sales provisions now contained in §§44(a) and (b).* See *Burnet v. S. & L. Building Corp.*, 288 U. S. 406 (1933).

Section 44, dealing with the reporting of gain on the installment basis, like §42, dealing with gross income generally, does not purport to define realization. On the contrary, §44 postulates the determination of realized gain under other provisions of the statute and thereby negatives any suggestion that realization occurs only as amounts are returned as income under the computation which the section authorizes. Section 44(a) provides that an installment seller "may return as income * * * that proportion of the installment payments actually received * * * which the gross profit realized or to be realized when payment is completed, bears to the total contract price". In terms, therefore, the statute contemplates that the full amount of the gain may have been realized upon the sale.

The amount realized on an installment sale would be determined under §111.** Under that section a taxpayer

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* Section 44(a) deals with a person who regularly sells personal property on the installment plan. Section 44(b) provides that in certain cases a person who makes a casual sale of personal property or a sale of real estate may return the income therefrom in the manner prescribed by §44(a).

** Reg. 111, §29.111-1 provides:

"The general method of computing such gain or loss is prescribed by section 111 * * *.

"In the case of property sold on the installment plan, special rules for the *taxation* of the gain are prescribed in section 44.". (Italics added.)

selling on the installment basis realizes gain to the extent that the value of the property received exceeds basis (Reg. 111, §§29.44-4 and 29.111-1, *supra*). If the fair market value of the property received is less than the total selling price, additional gain will be realized in subsequent years when and if the obligations received are satisfied (*ibid.*). In any case, however, whether gain has been realized in full or whether all or a portion of the gain remains to be realized, the taxpayer is accorded the right to elect to report the gain under §44. But the fact that the taxpayer has such an election in no way detracts from the fact that the profits from the sale are realized in full under the provisions of §111 where, as here, the taxpayer receives the sales price in money or money's worth, i. e., where the obligations received are worth face.

Thirdly, the provisions of §111(d) plainly imply that the gain from an installment sale is realized in accordance with the provisions of §§111(a) and (b). Section 111(d) provides:

> "INSTALLMENT SALES.—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received."*

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* Petitioner's brief (p. 29) cites §111(d) for the proposition that the gain from an installment sale is "derived" only as payments are received. This contention is based on the Commissioner's treatment of the statutory phrase "in the year in which such payment is received" as modifying "gain or profit". The purpose of the subsection, however, is to sanction *taxation* "in the year in which such payment is received" of the portion of any installment payment representing gain or profit. Accordingly, the phrase "in the year in which such payment is received" is to be taken as modifying "taxation" and not "gain or profit" as the Commissioner would have it appear.

In substance the statute says that notwithstanding the fact that the gain from an installment sale is realized upon the sale it may, nevertheless, be *taxed* in subsequent years as installment payments are received. The use of the phrase "Nothing in this section shall be construed to prevent" shows that the subsection is a precaution against any claim that because gain was realized in the year of sale it may not be taxed in a subsequent year.* Such a precaution would not have been necessary if gain from an installment sale were realized only as payments were received.

In order to support his claim that the time of realization of the gain from an installment sale is governed by the time the gain is reported under §44, the Commissioner asserts (petitioner's brief, p. 29) that the term "taxation" as used in §111(d) "contemplates not only the imposition of the tax, but every step necessary thereto." In this manner it is implied that until gain is taxed it is not realized. This indeed is the silent premise of the Commissioner's argument based on the provisions of §§41-44 governing the time of taxation. But the underlying assumption that gain which is not taxed is not realized would not bear express assertion. Section 112 contains a long list of instances in which realized gain as determined under §111 is not recognized and hence is not subjected to tax. Additional instances of realized gains which are not subjected to tax for reasons other than non-recognition are contained in Point ID below.

3. The authorities are uniformly to the effect that gains from installment sales are realized in full in the year of sale where the obligations received are worth face.

In *Burnet* v. *S. & L. Building Corp.*, 288 U. S. 406 (1933), this Court had before it the question of the validity of

* An installment sales case in which this type of claim was made is *Louis Werner Saw Mill Co.* v. *Helvering*, 96 F. (2d) 539 (App. D. C., 1938).

the regulations promulgated by the Commissioner under §44, then §212(d) of the Revenue Act of 1926. The question arose in connection with sales of real estate by a taxpayer on the accrual basis who elected to report his gains on the installment basis. The precise question was the treatment to be accorded assumed mortgages in the computation of the portion of each payment to be reported in each year. In upholding the regulations the Court approved a determination by the Commissioner of the "realized profit" from the sales as the excess of the money and mortgages (both received and assumed) over the seller's basis. After pointing out that the purpose of the installment provisions was to alleviate the hardship on vendors of having to pay in a single year the total tax on installment sales, the Court said (p. 414):

> "The amounts which respondent realized as profits are not in question. These were subject to taxation either upon the accrual basis or, at the taxpayer's option, on the installment basis. Generally, the Commissioner's regulations permitted the tax payments to be spread over the period during which the taxpayer would receive funds, and divided these partly into return of capital and partly into profits actually collected."

Comm'r v. *Shenandoah Co.*, 138 F. (2d) 792 (C. C. A. 5th, 1943), relied upon by the court below, held that the gains from the installment sales there involved were both realized and recognized within the meaning of §115(l) in the year of sale.* The *Shenandoah* case presented the question whether

* In the *Shenandoah* case a corporation sold building lots in 1936 and 1937 on the deferred payment plan and elected to report its gains therefrom under §44 of the Revenue Act of 1936. The corporation, which was on the accrual basis of accounting, carried all the installment obligations on its books as receivables. Except

such profits were includible in full in earnings and profits for dividend purposes but, apart from the different bases prescribed in paragraphs 1 and 2 of §115(l), the includibility of amounts in earnings and profits is determined in exactly the same way for dividend purposes under paragraph 2 as for invested capital purposes under paragraph 1. (See petitioner's brief, pp. 13, 16.)

In holding that the Shenandoah Company's gains from its installment sales were realized in full in the year of sale the court said, per Hutcheson, Cir. J. (p. 794):

> "Usually, of course, the year of realization is the year of taxation, and this would be the case here but for the use of the installment option. This, while deferring payment of the taxes to a later year, does not change the fact that the income was in fact realized in the year in which the obligations were received. Indeed, it establishes that it was, for otherwise there would be no occasion to provide for deferring the payment. We think it plain, therefore, that the Tax Court was right in holding that dividends paid out of earnings taxable when received, under the Revenue Act applicable to the year in which the sales were made, though under the option not taxed to them in those years, were paid out of surplus, and allowable as a dividends paid credit, and that its judgment must be affirmed."

Circuit Judge Holmes dissented solely on the question of recognition discussed *infra*. He said (p. 795):

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for the fact that the corporation availed itself of the provisions of §44, all of its profits from the sales would have been taxable income in the year of sale. The corporation made a distribution to its stockholders in 1937. It showed a surplus available for such distribution by including in its earnings and profits the gain represented by its uncollected installment obligations. The Commissioner contended that such gain was not includible in earnings and profits and that the corporation was therefore not entitled to a dividend carry-over from 1937 to 1938 under the provisions of §27(b)(2) of the Revenue Act of 1936.

> "Its [the corporation's] profits were realized in 1937, but were not recognized in its tax returns because it elected to exercise its option to report such income on the installment basis."

Even the decision of the Tax Court in the *Kimbrell* case, relied upon by the Tax Court in the present case, acknowledged that the gains involved in the *Shenandoah* case had been realized, the Tax Court saying with respect to the *Shenandoah* case that there "the total gain on the sale of each lot was realized at the time of sale and under either the cash or accrual basis would have been taxable in the year thereof but for the election under section 44(b)" (7 T. C. 339, 344). The situation of the taxpayer in the *Shenandoah* case, both with respect to the facts of its installment sales and its method of keeping books and reporting income, is indistinguishable from the situation of the taxpayer in the present case and the Tax Court in its decision below made no attempt to distinguish the two situations.

The decision of the Circuit Court of Appeals for the Fourth Circuit in the *Kimbrell* case (159 F. (2d) 608) held that the gains from the installment sales there involved were realized at the time of sale for the reasons given in the *Shenandoah* case and in the cases discussed immediately below.*

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*The Circuit Court of Appeals in the *Kimbrell* case also held that the gains in question were "recognized in computing net income under the law applicable to the year in which such sale or disposition was made." As the petitioner's brief points out (footnote 2), the facts of the *Kimbrell* case are different from those here involved in that the taxpayer there reported its income from installment sales for excess profits tax purposes on the accrual basis, pursuant to §736(a), although it continued to report such income for income tax purposes under §44. However, in attempting to show that the reasoning of the *Kimbrell* case has no applicability to the present case, the petitioner's brief states (footnote 2) that the decision in that case was rested:

In several cases arising under §44(d) the courts have held that gains from installment sales were realized in the year of sale. Section 44(d) was added by the Revenue Act of 1928 to prevent the evasion of taxes in connection with the seller's transfer of installment obligations to others who took them at an increased basis and as a result paid no additional income tax thereon except to the extent that amounts collected exceeded such basis. See Report of Committee on Ways and Means, H. R. Rep. No. 2, 70th Cong., 1st Sess., p. 16 (1939-1 C. B., Part 2, 384, 394). That report described the effect of the installment method as follows:

> "The installment basis accords the taxpayer the privilege *of deferring the reporting* at the time of sale of *the gain realized*, until such time as the deferred cash payments are made." (Italics added.)

In cases involving a tax assessed under §44(d) against a decedent, based on transmission of installment obligations at his death, the position was taken on behalf of the decedent's estate that, since no gain was realized upon the decedent's death, the tax was unconstitutional. In each case the court rejected the argument and held that, although no gain was realized upon the decedent's death, profits from the installment sales had been realized in the year of the sale and would have been taxable in such year except for

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"* * * upon the ground that, since the taxpayer there reported upon the accrual basis for purposes of the excess profits tax, uncollected profits on installment sales were 'recognized,' as well as realized (p. 612)—'*because they are taken into consideration in computing the part of the sales price to be included in the excess profits net income and subjected to the excess profits tax.*'" (Italics added.)

Actually, this reasoning is applicable to the present case, since the full amount of the taxpayer's profit from an installment sale was used in determining the fraction of each installment payment received which was reported as income for excess profits tax purposes as well as income tax purposes.

the privilege of deferring the tax granted by §44, which privilege was terminated at death.* In *Alexander M. Crane*, 30 B. T. A. 29 (1934), the Board of Tax Appeals said (p. 30):

"* * * the gain subject to tax on the death of the owner of installment obligations is the gain realized on the sale of the property in connection with which the installment obligations were received, and the taxation of which was merely deferred under the installment sales provisions of the taxing statute."

This decision was affirmed in *Crane* v. *Helvering*, 76 F. (2d) 99 (C. C. A. 2d, 1935), where the court said (pp. 100-101):

"The statute might have taxed at once a gain based upon the value of the bond and mortgage, for that was 'realized' as soon as they were received. *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U. S. 462 * * *; *Rusk* v. *Com'r.*, 53 F. (2d) 428 (C. C. A. 7); *Wolfson* v. *Reinecke*, 72 F. (2d) 59 (C. C. A. 7). It is true that in these cases the obligations were all short term notes, while here it was a bond and mortgage; but the principle is the same in either case. If a note or other promise, payable in a later taxable year, is 'realized' on its receipt, it can make no difference how long the payment is deferred; whether for ten years, or for only one."

In *Nuckolls* v. *United States*, 76 F. (2d) 357 (C. C. A. 10th, 1935), the court, in reaching a similar conclusion, said (p. 360):

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* Petitioner's brief states (footnote 11) that this line of cases supports the view that realization (and recognition) of the gain from an installment sale take place "at least in part" in the year in which the installment obligations were disposed of. This suggestion is not well founded because, as stated above, one of the reasons for adding subsection (d) was that no gain is realized on transmission by death.

"* * * the sale made on November 2, 1929, gave rise to taxable income in the amount of the difference between $33,600 and the price for which the stock was sold—$105,000 if the notes were then worth their face. Whatever their value, the gain, if any, was then realized and taxable. The taxpayer was given the option to pay a tax on only a part of the realized gain during that year upon condition that if he died or sold the notes, he would pay an additional tax calculated on the then value of the notes."

In accord are *Lawler* v. *Comm'r*, 78 F. (2d) 567 (C. C. A. 9th, 1935) and *Moore* v. *United States*, 80 Ct. Cls. 842, 10 F. Supp. 143 (1935), *cert. denied*, 296 U. S. 583 (1935). See *Gump* v. *Comm'r*, 124 F. (2d) 540, 543 (C. C. A. 9th, 1941), *cert. denied*, 316 U. S. 697 (1942); *Estate of Henry H. Rogers*, 1 T. C. 629, 639 (1943), *aff'd*, 143 F. (2d) 695 (C. C. A. 2d, 1944).

D. The taxpayer's profits on its installment sales were recognized in full under the law of the year of sale.

As stated above, §111(c) provides that the extent to which the gain or loss from a sale "shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112," and §112(a) provides that upon a sale "the entire amount of the gain or loss, determined under section 111, shall be recognized," with exceptions not material here. The taxpayer's position is that since the full amount of the gains from its installment sales was recognized under the provisions of §112 which were in effect in the year of each sale,* such gains satisfy the recognition requirement of §115(l).

* The laws applicable to the years in which the sales here in question occurred are the Revenue Act of 1936, the Revenue Act of 1938, and the Internal Revenue Code, as the same have been amended. There is no significant difference in the relevant provisions of §§44, 111, 112 and 115(l) as they appear in the several Acts here applicable.

Although the petitioner's brief does not stress the point, it appears to adhere to the position heretofore taken by the Commissioner that the phrase contained in §115(l), "recognized in computing net income under the law applicable to the year in which such sale or disposition was made," does not refer to gain or loss recognized under §112 of the Code and corresponding provisions of prior Revenue Acts, but refers to gain (or loss) which the taxpayer has included in (or deducted from) taxable income. In the petitioner's brief the contention appears at pages 8 and 29 as an assertion that gain from an installment sale is recognized only as cash payments are actually received and reported under §44. (This construction of the phrase "recognized in computing net income," is hardly consistent with the statement at page 27 of petitioner's brief that "the foregoing provision merely fixes the law in effect during the year of sale as being controlling." See discussion *infra*, p. 35.)

It is submitted that the court below correctly rejected such contention on the authority of the decision of that court in the *Shenandoah* case (138 F. (2d) 792), discussed above (pp. 22-24). In answer to a similar contention, the court in the *Shenandoah* case said (p. 794):

> "* * * Nothing in Sec. 501 [§115(l)] limits, or purports to limit, earnings and profits from sales of property to those which were 'recognized' by the taxpayer as taxable to him in the year in which the dividend was declared. It merely limits them to such as were 'recognized', in computing net income, under the law applicable to the year in which the sales were made, and it stands conceded that the Revenue Act of 1936, the law applicable, clearly recognizes the receipts in this case as gains, and,

but for the option to defer payment of taxes on them it would have subjected the taxpayer to taxes on them in the year of their receipt. All that Section 501 [§115(l)] does, all that it was intended to do, is to limit usable earnings and profits from sales of property to that portion of the gain realized which is taxable, and there is nothing in it which restricts such usable profits to those gains only which are returned for taxation in the year of their realization."

The construction placed upon §115(l) in the *Shenandoah* case is, of course, the construction for which the taxpayer contends here. It is supported by analysis of the language of §115(l), the provisions of the regulations promulgated thereunder, and the legislative history of the section.

1. **Section 115(l) was designed to provide for the inclusion in earnings and profits of gain or loss which had not entered into the computation of taxable income.**

(a) *Section 115(l) provides for inclusion in total earnings and profits of increase in value accrued before March 1, 1913 which has not been subjected to tax.*

Paragraph 1 of §115(l) prescribes certain rules which are to be used in the computation of the total earnings and profits of a corporation for the purpose of determining its invested capital. It provides that in computing total earnings and profits the amount of the gain or loss from the sale or other disposition (after February 28, 1913) of property shall be determined by the use of the adjusted basis for determining gain (as defined in §113(b)), except that no regard is to be had to the value of the property as of March 1, 1913. In the computation of taxable income, however, §113(a)(14) provides that, in the case of property acquired before March 1, 1913, if the fair market value of the property as of March 1, 1913 is greater than its adjusted basis

at that date, then the basis for determining gain shall be such fair market value.

The result is that in such a case (*i. e.,* where March 1, 1913 value exceeds adjusted basis at that date) the amount of the gain determined under paragraph 1 of §115(l) for the purpose of inclusion in total earnings and profits would be greater than the amount of the gain determined under §113(a)(14) for the purpose of computing taxable income.*

The point may be illustrated as follows: A corporation acquired non-depreciable property in 1910 for $1,100. On March 1, 1913 the fair market value of the property was $2,200. In 1942 the corporation sold the property for $3,000. Under paragraph 1 of §115(l) the full gain of $1,900 would be includible in total earnings and profits. That is because under paragraph 1 of §115(l) such gain is determined without regard to the value of the property as of March 1, 1913. And yet $1,100 of such $1,900 gain would *not* have entered into the computation of the corporation's taxable income, and no tax would have been paid thereon, because under §113(a)(14) regard *is* had to March 1, 1913 value in determining the basis of the property for the purpose of computing the tax.**

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* The Regulations under §115(l) point out that there may be a disparity between the taxable income arising from a sale and the effect of the sale on earnings and profits. Reg. 111, §29.115-12 provides:

> "The 'recognized' gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(l) *as distinguished from the realized gain or loss used in computing net income.*" (Italics added.)

** The foregoing example is substantially the same as Example 2 contained in the Regulations promulgated under §115(l) (Reg. 103, §19.115-12, now contained in Reg. 111, §29.115-12). That example is of a case where "for the purpose of computing net income the gain is only $800" but where the total earnings and profits are "increased by $1,900."

The provision:

> "Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made."

applies to the gain determined under paragraph 1 of §115(l) and requires inclusion in the total earnings and profits of the full amount of such gain—both the part thereof which is includible in taxable income and the part thereof which is not. If that were not so, *i. e.*, if the untaxed portion of the gain were deemed not to be "recognized in computing net income under the law applicable to the year in which such sale or disposition was made," then the very purpose of providing in paragraph 1 that "no regard shall be had to the value of the property as of March 1, 1913" would be defeated. That purpose was to include in total earnings and profits the increase in value of property accrued before March 1, 1913 when subsequently realized, notwithstanding that such increase is not subjected to tax because of the provisions of §113(a)(14). Therefore, increase in value accrued before March 1, 1913 and realized thereafter must be deemed to be "recognized in computing net income under the law applicable to the year in which such sale or disposition was made."

This analysis shows that the full amount of gain from a sale may be "recognized in computing net income under the law applicable to the year in which such sale or disposition was made" although only a portion of such gain is taxed under the law applicable to such year, and that all that is necessary in order for gain to be recognized within the meaning of §115(l) is that the gain be of a kind that was

recognized under the provisions of §112 of the Code or corresponding provisions of prior Acts applicable to the year of sale. The fact that gain is not taxed in the year of sale, whether because of statutory exclusion from gross income or for some other reason (other than non-recognition thereof under the law of the year of sale), is immaterial.

(b) *The taxpayer's construction of §115(l) is confirmed by the provision regarding wash sales, added to the section by the Revenue Act of 1942.*

Section 146(a) of the Revenue Act of 1942 amended §115 (l) by adding the following sentence:

> "For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized."

The purpose of this amendment was stated by the Committee on Ways and Means in H. R. Rep. No. 2333, 77th Cong., 2d Sess. (1942-2 C. B. 372, 442), as follows (pp. 92-93):

> "Under section 115(l) of the Code reference is made to the basis of property prescribed by section 113, and unrecognized gains or losses are disregarded, in computing the earnings or profits of a corporation resulting from a disposition by it of such property. While section 118 of the Code disallows a loss from wash sales of securities, and section 113 (a)(10) adjusts the basis of the new securities for the amount of the disallowed loss, *no provision in the Code specifies that the disallowed wash-sale loss shall be considered as not recognized* for the purposes of computing such earnings and profits. Thus, an improper duplication results in the computation of earnings and profits under section 115(l), contrary to the uniform practice prior to the enactment of sec-

tion 501 of the Second Revenue Act of 1940." (Italics added.)

The amendment made to the statute in 1942 would have been unnecessary under the Commissioner's construction of §115(l). The loss from a wash sale is not allowed as a deduction (§118). Therefore, such a loss could not have affected earnings and profits if, as the Commissioner contends, gain or loss must enter into the computation of taxable income before it can be considered "recognized" within the meaning of §115(l). Congress considered, however, that a loss from a wash sale was recognized within the meaning of §115(l) because such a loss, although not deductible, was recognized under §112. And, as the above-quoted committee report shows, Congress amended the statute not because the loss from a wash sale is excluded from the computation of taxable income but because, under §113(a)(10), such loss is added to the basis of the property reacquired, which would ultimately result in a double reduction of earnings and profits on account of a single loss. The construction which Congress placed upon §115(l) when it made this amendment is, therefore, directly opposed to the Commissioner's contention.

(c) *The meaning which the Commissioner would give the phrase "recognized in computing net income" conflicts with the construction required by the phrase which follows immediately, "under the law applicable to the year in which such sale or disposition was made".*

In the court below the brief for the Commissioner made the easy assumption that the words "recognized in computing net income" meant included in or deducted from taxable income. From this it was argued that gains from installment sales which had not been included in taxable income were not recognized within the meaning of §115(l).

In addition to the internal conflict to which such a construction of the statute would lead, as shown above, it would have the further effect of depriving the statute of sensible meaning because it would exclude from earnings and profits gain or loss included in or deducted from taxable income in a year subsequent to the year of sale.

If, as the Commissioner has contended, the words "recognized in computing net income" are to be construed as saying "included in or deducted from taxable income" the statutory phrase would then read: "Included in or deducted from taxable income under the law applicable to the year *in which such sale or disposition was made.*" But a taxpayer can compute its net income for any year only under the law applicable to that particular year. Therefore, if gain or loss is reported or deducted in a year subsequent to the year of sale, it is included in the computation of net income under the law applicable to such subsequent year.*

It follows that *if* the Commissioner's construction of §115(l) were correct (that only gains or losses which have been included in or deducted from taxable income are "recognized in computing net income" within the meaning of the statute), then *whenever gain or loss is reported in a year subsequent to the year of sale such gain or loss could never affect earnings and profits* under §115(l) because it would have been included in the computation of taxable income under the law applicable to the subsequent year rather than "under the law applicable to the year in which such sale or disposition was made".

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* For this reason it has been held that an installment payment received in 1938 on account of an installment sale made in 1936 is taxable in accordance with the capital gains provisions in effect in 1938 rather than those in effect in 1936. *Harry B. Golden*, 47 B. T. A. 94 (1942).

The consequence of such a construction in the case of installment sales would be that all gains reported in years subsequent to the year of sale could be distributed by the selling corporation to its stockholders free of the tax on dividends. On the other hand, where a loss was excluded from the computation of taxable income in the year of sale (e.g., the excess of capital losses over capital gains under §117(d)(1)) but carried over to a subsequent year where it was allowable as a deduction to the extent of capital gains of that year (§117(e)), the loss could never decrease earnings and profits because it would be allowed as a deduction in the computation of net income only under the law of a year subsequent to the year of sale.

The consequence is that the phrase "recognized in computing net income under the law applicable to the year in which such sale or disposition was made" can be given a sensible meaning only by construing it, as the *Shenandoah* case did, as referring to gain or loss of the kind recognized under the provisions of §112 of the Code, or corresponding sections of the prior Revenue Acts, applicable to the year of sale, rather than to gain or loss that has been included in computing taxable income.

Petitioner's brief (p. 27) misinterprets the foregoing contention of the taxpayer and endeavors to answer it by pointing out that the phrase in question "merely fixes the law in effect during the year of sale as being controlling". But this argument of the Commissioner gives the phrase the construction for which the taxpayer contends, viz., that under the phrase "recognized in computing net income under the law applicable to the year in which such sale or disposition was made" the test is not whether the gain has been subjected to tax in the year of sale or at any other time but whether the gain is *of the kind* which was recognized under the law of the year of sale. Such construction of the phrase

"recognized in computing net income under the law applicable to the year in which such sale or disposition was made" is quite the opposite of its construction as meaning included in or deducted from taxable income.

2. The Treasury Regulations promulgated under §115(l) acknowledge that recognition under §115(l) is governed by the provisions of §112 and not by inclusion of gain or loss in taxable income.

The taxpayer's construction of §115(l) is entirely supported by the following provisions of the Regulations thereunder (Reg. 111, §29.115-12):

> "The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term 'recognized' has reference to *that kind* of realized gain or loss *which is recognized for income tax purposes by the statute* applicable to the year in which the gain or loss was realized, for example, see section 112.* *A loss* (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) *may be recognized though not allowed as a deduction* (by reason, for example, of the operation of sections 24(b) and 117 and corresponding provisions of prior revenue laws) *but the mere fact that it is not allowed does not prevent decrease in*

* Reg. 111, §29.115-3 contains the following cross-reference to this section of the Regulations:

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12)."

earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The 'recognized' gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(l) *as distinguished from the realized gain or loss used in computing net income.*" (Italics added except as to word "recognized" in first sentence.)*

Section 24(b) provides, among other things, that no deduction shall be allowed in respect of a loss from the sale of property by a corporation to an individual controlling more than half of its stock. Nevertheless, since such loss is recognized under §112, the above-quoted regulations provide that it shall decrease earnings and profits.

Section 117(d)(1) provides, in the case of corporations, that losses from sales of capital assets shall be allowed only to the extent of gains from such sales. But although the excess of such losses over such gains is not allowed as a deduction, such excess is recognized under §112 and, therefore, the above-quoted Regulations provide that such excess of loss shall decrease earnings and profits.

So also a gain may be recognized though not includible in taxable income, but the fact that it is not so includible does not prevent increase in earnings and profits by the amount thereof. The example given in the Regulations is discussed above, in Point ID(1), paragraph (a). Another

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* Except for the references to losses disallowed under §118 (discussed in paragraph (b) of Point ID(1)), the language of this Regulation is largely borrowed from the committee reports. See Sen. Rep. No. 2114, 76th Cong., 3rd Sess., p. 23 (1940-2 C. B. 528, 545) and H. R. Rep. No. 3002, 76th Cong., 3rd Sess., p. 60 (1940-2 C. B. 548, 563).

illustration is afforded in the case of distributions by a foreign corporation to United States stockholders. (The provisions of §115 apply to such distributions. *Untermyer* v. *Comm'r*, 59 F. (2d) 1004 (C. C. A. 2d, 1932), *cert. denied*, 287 U. S. 647 (1932); Reg. 111, §29.115-1.) Where a foreign corporation, not engaged in trade or business within the United States, sells securities here at a gain, such gains are not included in the corporation's taxable income (§231(a)). But even though no tax had been paid thereon, such gains would undoubtedly be regarded as recognized within the provisions of §115(l) so as to constitute part of the corporation's earnings and profits for the purpose of determining whether distributions by the corporation to United States stockholders were taxable as dividends.

3. The legislative history of §115(l) fully supports the taxpayer's construction of that section as referring to gains recognized under §112 rather than gains included in computing taxable income.

The particular change in preexisting case law which the provisions of §115(l) here in question was intended to effect, was to establish a correspondence, so far as sales and exchanges are concerned, between earnings and profits and the recognition provisions of §112. This is shown by the following passage of the report of the Committee on Ways and Means on the bill proposing §115(l) (H. R. Rep. No. 2894, 76th Cong., 3rd Sess., pp. 41-2; 1940-2 C. B. 496, 526):

> "Section 401 of the bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by *the*

entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115(h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome*, (60 F. (2d) 931) and following decisions, *the rule effectuates the provisions of section 112.* While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits." (Italics added.)

The report continues with a reference to *Comm'r* v. *F. J. Young Corp.*, 103 F. (2d) 137 (C. C. A. 3rd, 1939) as such a case. As petitioner's brief states (footnote 10) it was the purpose of §115(l) to overrule the *Young* case. The sole question involved in the *Young* case was whether a realized gain should be included in a corporation's earnings and profits where §112(b)(5) of the Revenue Act of 1928 expressly provided that such gain should not be recognized. The *Young* case held the gain includible. Other cases which had declined to apply the recognition provisions in the computation of earnings and profits were *Comm'r* v. *McKinney*, 87 F. (2d) 811 (C. C. A. 10th, 1937) and *Comm'r* v. *W. S. Farish & Co.*, 104 F. (2d) 833 (C. C. A. 5th, 1939).

The reference in the report to Treasury practice shows a purpose to incorporate into the Code provisions substantially similar to those which had been contained in the Regulations since 1934,* to wit:

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* Reg. 86, Art. 115-1, under the 1934 Act; Reg. 94, Art. 115-3, under the 1936 Act; Reg. 101, Art. 115-3, under the 1938 Act; Reg. 103, Sec. 19.115-3, under the Internal Revenue Code. These Regulations contained nothing comparable to the provision added to the Regulations by the 1941 amendment upon which the Commissioner relies here (Petitioner's brief, Point A).

"Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section."

. . . . .

The legislative history shows no purpose on the part of Congress to define earnings and profits in terms of income that had been subjected to tax. And yet the important differences which had long existed between the determination of earnings and profits and the computation of taxable income could hardly have escaped Congressional notice. The Regulations have long contained a provision for inclusion in earnings and profits of "all income exempted by statute" and income not taxable under the Constitution (Reg. 111, §29.115-3). The differences existing between the determination of earnings and profits and the computation of taxable income had also frequently been stated by the courts and the Board of Tax Appeals. For example, in *R. M. Weyerhaeuser*, 33 B. T. A. 594 (1935) it was said (p. 597):

"Earnings and profits, on the other hand, are not defined by the act; but they have a settled and well defined meaning in accounting. Generally speaking, they are computed by deducting from gross receipts the expense of producing them. *Mobile & Ohio Railroad* v. *Tennessee*, 153 U. S. 486, 497; Fletcher Cyclopedia Corporations, vol. 6, p. 6092. Thus, under the ordinary method of accounting, in computing earnings and profits there will be deducted, not only the items shown above, but others which are not, under the statute, deductible in computing taxable net income. In this classification may be listed such items as extraordinary expenses, charitable contributions, taxes paid the Federal Government, and taxes assessed against local benefits tending to increase the value of the property [citing cases]. Again, many

items, such as interest upon the obligations of a state or political subdivision, tax-free Federal securities, and dividends from other corporations, must necessarily be considered in computing earnings and profits, though forming no part of taxable net income."*

When the legislative history of §115(l) is considered against this background, it seems apparent that by the provisions in question Congress was seeking to do only one thing, to wit, to make the recognition provisions of §112 govern the determination of earnings and profits in the case of sales, and that Congress had no purpose to go beyond the recognition provisions and make inclusion of gain in earnings and profits dependent upon whether it had been subjected to tax.

II.

The change in the Regulations upon which the Commissioner relies is, as to installment sales, in conflict with the provisions of §115(l) and therefore is invalid.

In Point I of this brief it has been shown that the taxpayer's gains from its installment sales are required by §115(l) to be included in the taxpayer's earnings and profits at the dates involved because, at such dates, the

* Among the numerous instances, in addition to those mentioned in the quotation, of items which affect taxable income differently than they affect earnings and profits are: net operating loss carry-overs and capital loss carry-overs (which decrease taxable income but do not decrease earnings and profits); recoveries of bad debts and prior taxes excluded from income under §22(b)(12) and the proceeds of life insurance policies excluded from income under §22(b)(1) (which increase earnings and profits but are not included in taxable income); and expenses disallowed under §24(c) and premiums on life insurance disallowed under §24(a)(4) (which decrease earnings and profits but do not decrease taxable income).

gains satisfied the only two tests specified in §115(l), viz., realization and recognition. It is therefore immaterial that such gains did not meet a third test, imposed by an amendment made to the Commissioner's regulations in 1941, that installment gains be reported in taxable income before inclusion thereof in earnings and profits.*

The taxpayer submits that the change in the Regulations is, as to installment sales, in conflict with the statute

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* By T. D. 5059 of July 8, 1941 (1941-2 C. B. 125) the following provisions were added to Reg. 103, §19.115-3 (now Reg. 111, §29.115-3):

> "* * * the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. *For instance, * * * a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis;* * * *." (Italics added.)

Prior to such amendment, the Commissioner had promulgated the Regulations under §115(l) which did not impose any requirement of the kind imposed by the above-quoted amendment. (T. D. 5024 of December 19, 1940; 1940-2 C. B. 110.) The Regulations promulgated under §115(l) were contained in §19.115-12 of Reg. 103, and are now contained in Reg. 111, §29.115-12.

The same Treasury decision (T. D. 5059) which made the above-quoted amendment also amended Reg. 109, §30.718-2 (relating to the meaning of "accumulated earnings and profits" for purposes of the excess profits tax) by adding a specific reference to the provisions of Reg. 103, §19.115-3, as amended, "relating to the computation of earnings and profits in the case of a corporation computing net income on the cash, accrual, or installment basis * * *". Reg. 109, §30.718-2 as so amended, was superseded, however, by Reg. 112, §35.718-2 in which all reference to the provisions added by the 1941 amendment was omitted. Regulations 112, which were promulgated January 25, 1944, were made applicable to taxable years beginning after December 31, 1941 and also "where it is appropriate" to taxable years beginning after December 31, 1939 and before January 1, 1942.

In view of the above history of the changes in the Regulations and the fact that the only reference in Reg. 112, §35.718-2 to the Regulations under §115 is to "certain transactions" rather than to accounting methods, it seems unwarranted to state, as the petitioner's brief does (p. 16), that such reference "leaves no doubt" that the 1941 amendment applies here.

and therefore invalid. *Trust of Bingham* v. *Comm'r,* 325 U. S. 365 (1945). As this Court said in *Koshland* v. *Helvering,* 298 U. S. 441, 447 (1936): "But where, as in this case, the provisions of the act are unambiguous, and its directions specific, there is no power to amend it by regulation." And if there were no such conflict here between §115(l) and the amended Regulation, there would then be a serious question whether the Regulation, as it is sought to be applied here with respect to the taxpayer's installment sales, was a proper exercise of the Commissioner's discretion. As the Circuit Court of Appeals for the Fourth Circuit said in the *Kimbrell* case (159 F. (2d) 608, 611):

> "When the intrinsic nature of the uncollected profits on installment obligations is considered, no reason appears why they should not be treated as a part of the invested capital credit within the meaning of the phrase 'accumulated earnings and profits' contained in Section 718(a)(4) of the Code. They are assets of the business which can be pledged or sold and may be subjected to attachment or execution."

A. The change in the Regulations cannot be justified on the theory that it deals merely with the time when gain or loss is included in earnings and profits. The question of the time of inclusion is governed by §115(l).

Petitioner's brief attempts to justify the change in the Regulation in question on the ground that it deals merely with the time when gains from installment sales increase earnings and profits—a matter which, it is implied, is not controlled by §115(l). Petitioner's brief points out (pp. 8, 30) that the provisions of §111, defining realization, and of §112, defining recognition, do not contain any provision regarding the time when gain or loss enters into the computation either of net income or earnings and profits.

The argument is that since the time for inclusion of realized and recognized gains in taxable *income* is governed by the provisions of §§41-44, the same sections should be considered as governing the inclusion of items of gain in *earnings and profits.* By failing to discuss the provisions of §115(l) as to time of inclusion of gains in earnings and profits, petitioner's brief implies that the section does not specify the time of inclusion, so that the Commissioner is left free to provide for this omission by regulation. The answer to this contention is that §115(l) *does* provide for the time of inclusion of gain or loss in earnings and profits.

The section provides how earnings and profits are to be determined. Earnings and profits can be determined only as of a given date. The date is always essential. Section 115(l) provides, therefore, that if, at any date as of which earnings and profits are to be determined, gain or loss has been realized and has been recognized under the law of the year of sale, such gain or loss "shall increase or decrease the earnings and profits" on such date. The language of the statute is mandatory, and gives neither the Commissioner nor the corporation power to postpone the inclusion of any gain in earnings and profits once such gain has met the tests of realization and recognition. It is, therefore, beside the point to argue that the Regulation in question deals only with the time of inclusion of gain or loss in earnings and profits. The question of time of inclusion in earnings and profits is the very question which the statute was designed to settle and there is no room for importing therein the provisions of §§41-44 dealing with the time of inclusion of gain in taxable income.*

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* As to items which are not controlled by §115(l), the taxpayer does not contend that the time of inclusion of income in earnings and profits of items of income and expense may not appropriately be determined by the method of accounting employed by a tax-

B. The change in the Regulations cannot be justified on the basis of the holding of the *Wheeler* case that the includibility of gains from sales in earnings and profits is to be determined under the provisions of §112.

Petitioner's brief asserts (p. 21) that the holding of this Court in *Comm'r* v. *Wheeler*, 324 U. S. 542 (1945), "correlates not only the extent to which, but the time when, gain shall be brought into earnings and profits with the extent to which and the time when such gain shall enter into the computation of net income." This statement is incorrect. The *Wheeler* case correlates earnings and profits with recognition under §112.

The *Wheeler* case involved the question of the effect on a corporation's earnings and profits of a sale by the corporation of securities for which its basis as determined under §113 was lower than the book value of the securities as determined in accordance with principles of corporate accounting. The proceeds of the sale exceeded the tax basis but were less than the book value. As a result, the corporation had a realized gain under §111 of the Revenue Act of 1938 which was recognized in full under the provisions of §112 of that Act although from an accounting point of view it

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payer." Indeed, the legislative history of §115(l) indicates that Congress contemplated that apart from the matters covered by the section, earnings and profits would be determined in accordance with the best accounting practice. See H. R. Rep. No. 2894, 76th Cong., 3rd Sess. 43 (1940-2 C. B. 496, 527).

Since the question here is controlled by §115(l), it is unnecessary to discuss whether the installment basis is "a separate and independent method of accounting and one that is co-equal with the cash and accrual bases", as stated in petitioner's brief (p. 23). However, it may be doubted whether a statutory basis of return, which is applicable only to certain items of gross income, and which is not at all applicable to deductions, should be regarded as an independent method of accounting. The situation of the taxpayer illustrates the point. It was stipulated, and the Tax Court found, that the taxpayer keeps its books and files its tax returns on the *accrual* basis but that it elected, with respect to certain transactions, to report the gain therefrom on the basis authorized by §44 (R. 26, 31).

had suffered a loss on the transaction. This Court held that notwithstanding the fact that the corporation had suffered a loss from an accounting point of view, its earnings and profits were to be increased by the amount of the gain recognized under §112 of the Revenue Act of 1938.

The Court rejected the contention that earnings and profits were to be determined in accordance with accounting costs instead of tax basis and held that the recognition provisions of §112 were controlling not only in the determination of taxable gain but in the determination of earnings and profits. In so holding the Court said (p. 546):

> "It was no doubt permissible and perhaps the correct accounting, for determining earned surplus for dividends and such corporate purposes, for the corporation to set up its books on the market value of its property at the time of acquisition, which determined the value of the stock it issued. *But 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either.*" (Italics added.)

The change in the Regulation, which is based on accounting principles rather than on the provisions of §112, certainly cannot be justified by the *Wheeler* case.

The Court's holding was made independently of §115(l) which had been enacted in 1940, subsequent to the year involved. The Court reasoned that, by §112, Congress had "determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences" and that it was sensible and, indeed, required by the provisions of §111(c), that such determination be reflected in the computation of earnings and profits. Clearly, installment sales do not fall within the category of transactions which Congress has deemed not definitive enough

to be given tax consequences. All that §44 does is to grant an option to spread the payment of the tax on a transaction which would otherwise be taxed immediately.

The dissenting judge in the court below thought that the *Shenandoah* case had "in principle been overruled" by the *Wheeler* case (R. 54). The Commissioner so argued in the court below but such argument is not made here. Petitioner's brief does state (footnote 10) that the *Shenandoah* case was based "at least in part" upon the theory of the *Young* case, and similar cases, which were overruled both by §115(l) and by the *Wheeler* case. Examination of the opinion in the *Shenandoah* case will show that the Commissioner there argued that such line of cases had been abrogated by §115(l) and that the court referred to such cases not as authority but merely in the course of reciting what the Tax Court had done. The opinion in the *Shenandoah* case was squarely rested upon the provisions of §115(l). The fact is that the *Shenandoah* case holds on the authority of §115(l) what this Court held in the *Wheeler* case without the benefit of the statute, viz., that realized gains from sales, to the extent recognized under §112, are includible in earnings and profits.

C. The change in the Regulations cannot be justified under lower court decisions rendered prior to the enactment of §115(l).

Petitioner's brief (Point B(1)) refers to certain lower court cases decided under the Revenue Act of 1918 as affording "ample historical justification" for the provision of the Regulation regarding installment sales. Those cases held, on accounting principles, that uncollected profits on installment sales were not includible in invested capital under the excess profits tax imposed by the Revenue Act of 1918. Such cases are not authority, of course, in a case

governed by §115(l), which, so far as sales or other dispositions of property are concerned, has removed the determination of earnings and profits from the domain of accounting and substituted instead the statutory tests of realization and recognition. As stated above, §115(l) was apparently overlooked by the Tax Court in the *Kimbrell* case, *which relied upon this line of cases.*

Conclusion.

Under the provisions of the statute the taxpayer's gains from its installment sales were realized in full in the year of sale and were recognized in full under the law of the year of sale. Such gains are, therefore, required by the express provisions of §115(l) to be included in the taxpayer's earnings and profits at the dates in question, and accordingly enter into the determination of the taxpayer's invested capital under the provisions of §718(a)(4). The change in the Regulations, which would impose the additional requirement that the gains from installment sales be returned for taxation before inclusion thereof in earnings and profits, is in conflict with §115(l) and cannot be permitted to exclude from earnings and profits gains which are required to be included therein by §115(l).

The judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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Appendix

Internal Revenue Code:

Chapter 1—Income Tax

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SUBCHAPTER B—GENERAL PROVISIONS

* * * * * *

Part II—Computation of Net Income

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SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * * *

(f) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111. * * *

(26 U. S. C. 1940 ed., Sec. 22.)

* * * * * *

Part IV—Accounting Periods and Methods of Accounting

Sec. 41. General rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U. S. C. 1940 ed., Sec. 41.)

Sec. 42. Period in which items of gross income included.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 42, as amended by Section 114 of the Revenue Act of 1941, 55 Stat. 687.)

* * * * * *

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations ~~prescribed by the~~ Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personality* [*sic*].—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

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(26 U. S. C. 1940 ed., Sec. 44.)

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SUBCHAPTER C—SUPPLEMENTAL PROVISIONS

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Supplement B—Computation of Net Income
[Supplementary to Subchapter B, Part II]

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(26 U. S. C. 1940 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, de-

termined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * *

(14) *Property Acquired Before March 1, 1913.*—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

* * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 113.)

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SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * *

(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—

The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized.

* * *

(26 U. S. C. 1940 ed., Sec. 115, as added by §501 of the Second Revenue Act of 1940, 54 Stat. 974, 1004,

and amended by §146(a) of the Revenue Act of 1942, 56 Stat. 798, 841.)

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Chapter 2—Additional Income Taxes

* * * * * * *

SUBCHAPTER E—EXCESS PROFITS TAX [as added by Section 201 of the Second Revenue Act of 1940, *supra*, which provided that the new subchapter may be cited as the "Excess Profits Tax Act of 1940"].

PART I

* * * * * * *

SEC. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b).—

* * * * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * * * *

(26 U. S. C. 1940 ed., Sec. 718.)

SEC. 728. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1. (26 U. S. C. 1940 ed., Sec. 728.)

Treasury Regulations 111:

SEC. 29.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February

28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115—12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

• • • • • •

SEC. 29.115-12. *Effect on Earnings and Profits of Gain or Loss Realized After February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (l) prescribes certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the rules herein prescribed for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under (1) such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under (2) there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. * * *

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection, the term "recognized" has reference to that kind of realized gain or loss

which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115 (l) as distinguished from the realized gain or loss used in computing net income. The application of this paragraph may be illustrated by the following examples:

* * * * * *

Example (2). On January 2, 1910, the M Corporation acquired nondepreciable property at a cost of $1,000. On March 1, 1913, the fair market value of such property in the hands of the M Corporation was $2,200. On December 31, 1942, the M Corporation transfers such property to the N Corporation in exchange for $1,900 in cash and all the N Corporation stock, which has a fair market value of $1,100. For the purpose of computing the total earnings and profits of the M Corporation the gain on such transaction is $2,000 (the sum of $1,900 in cash and stock worth $1,100 minus $1,000, the adjusted basis for computing gain, determined without regard to March

1, 1913, value), $1,900 of which is recognized under section 112 (c), since this was the amount of money received, although for the purpose of computing net income the gain is only $800 (the sum of $1,900 in cash and stock worth $1,100, minus $2,200, the adjusted basis for computing gain determined by giving effect to March 1, 1913, value). Such earnings and profits will therefore be increased by $1,900. In computing the earnings and profits of the M Corporation for any period beginning after February 28, 1913, however, the gain arising from the transaction, like the taxable gain, is only $800, all of which is recognized under section 112 (c), the money received being in excess of such amount. Such earnings and profits will therefore be increased by only $800 as a result of the transaction. For increase in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913, see section 29.115-14.

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Treasury Regulations 112:

Sec. 35.718-2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. * * *

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